



Report on Audits of Combined Financial Statements and Supplemental Information

as of June 30, 1998, and for the year then ended

REPORT OF INDEPENDENT ACCOUNTANTS

Teachers' Retirement Board
State Teachers' Retirement System

In our opinion, based upon our audits and the report of other auditors, the accompanying combined statements of plan net assets and the related combined statements of changes in plan net assets present fairly, in all material respects, the plan net assets of the State Teachers' Retirement System (System), a component unit of the State of California, as of June 30, 1998, and the changes in plan net assets for the year then ended in conformity with generally accepted accounting principles. These financial statements are the responsibility of the System's management; our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of the System's 403(b) Program. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion on those financial statements is based solely on the report of the other auditors. We previously audited and reported on the financial statements of the System for the year ended June 30, 1997, the reporting entity totals of which are included for comparative purposes only. We conducted our audits of the financial statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for the opinion expressed above.

As discussed in Note 2 to the financial statements, the System adopted Government Accounting Standards Board (GASB) Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*.

Teachers' Retirement Board
State Teachers' Retirement System

Our audits were made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental information included in Schedules 1 and 2 is required under GASB Statement No. 25, *Financial Reporting For Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. The supplemental information included in Schedules 3 through 8 is presented for purposes of additional analysis and is not a required part of the financial statements. Such information for the years ended June 30, 1998, 1997, 1996, 1995, 1994 and 1993, has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion and based on the report of other auditors, is fairly stated in all material respects in relation to the financial statements taken as a whole.

PricewaterhouseCoopers LLP

Sacramento, California
October 12, 1998

STATE TEACHERS' RETIREMENT SYSTEM
COMBINED STATEMENTS OF PLAN NET ASSETS
as of June 30, 1998
WITH REPORTING ENTITY TOTALS
as of June 30, 1998 and 1997
(In thousands)

| | <u>Teachers'</u> <u>Retirement</u> <u>Fund</u> | <u>Cash</u> <u>Balance</u> <u>Fund</u> | <u>403(b)</u> <u>Program</u> | <u>Reporting Entity Totals</u> | |
|---|--|--|---------------------------------|--------------------------------|----------------------|
| | | | | <u>1998</u> | <u>1997</u> |
| ASSETS | | | | | |
| Investments, at fair value: | | | | | |
| Short-term | \$ 1,725,028 | \$ 368 | \$ 13,508 | \$ 1,738,904 | \$ 1,994,718 |
| Debt securities: | | | | | |
| Directly held: | | | | | |
| Domestic | 17,752,345 | -- | 90 | 17,752,435 | 17,183,372 |
| International | 603,994 | -- | -- | 603,994 | 496,988 |
| Pooled - domestic | 8,529,149 | 608 | -- | 8,529,757 | 8,067,058 |
| Equities: | | | | | |
| Directly held: | | | | | |
| Domestic | 11,835,091 | -- | 11,588 | 11,846,679 | 9,719,328 |
| International | 18,525,360 | -- | 123 | 18,525,483 | 16,141,751 |
| Pooled - domestic | 24,896,824 | 1,000 | -- | 24,897,824 | 17,155,529 |
| Alternative | 1,983,165 | -- | -- | 1,983,165 | 1,366,122 |
| Real Estate | 2,061,342 | -- | -- | 2,061,342 | 2,428,341 |
| Securities lending collateral | 16,996,456 | -- | -- | 16,996,456 | 18,647,550 |
| Total investments | <u>104,908,754</u> | <u>1,976</u> | <u>25,309</u> | <u>104,936,039</u> | <u>93,200,757</u> |
| Cash and cash equivalents | <u>4,409</u> | <u>--</u> | <u>--</u> | <u>4,409</u> | <u>5,135</u> |
| Receivables: | | | | | |
| Investments sold | 292,493 | -- | -- | 292,493 | 235,198 |
| Foreign exchange contracts | 2,250,123 | -- | -- | 2,250,123 | 2,744,409 |
| Interest and dividends | 481,709 | 123 | 104 | 481,936 | 472,513 |
| Member/employer and other | 313,363 | -- | -- | 313,363 | 299,136 |
| Total receivables | <u>3,337,688</u> | <u>123</u> | <u>104</u> | <u>3,337,915</u> | <u>3,751,256</u> |
| Other assets | <u>534</u> | <u>--</u> | <u>64</u> | <u>598</u> | <u>3,956</u> |
| Total assets | <u>108,251,385</u> | <u>2,099</u> | <u>25,477</u> | <u>108,278,961</u> | <u>96,961,104</u> |
| LIABILITIES | | | | | |
| Payable for investments purchased | 438,784 | -- | -- | 438,784 | 389,720 |
| Payable for foreign exchange contracts | 2,204,647 | -- | -- | 2,204,647 | 2,744,650 |
| Benefits in process of payment | 295,666 | -- | -- | 295,666 | 269,271 |
| Other liabilities | 117,497 | 1,309 | 22 | 118,828 | 113,023 |
| Securities lending obligation | 16,996,456 | -- | -- | 16,996,456 | 18,647,550 |
| Total liabilities | <u>20,053,050</u> | <u>1,309</u> | <u>22</u> | <u>20,054,381</u> | <u>22,164,214</u> |
| Net assets held in trust for pension benefits (a schedule of funding progress is presented in Schedule 1) | <u>\$ 88,198,335</u> | <u>\$ 790</u> | <u>\$ 25,455</u> | <u>\$ 88,224,580</u> | <u>\$ 74,796,890</u> |

The accompanying notes are an integral part of these financial statements.

STATE TEACHERS' RETIREMENT SYSTEM
COMBINED STATEMENTS OF CHANGES IN PLAN NET ASSETS
for the year ended June 30, 1998
WITH REPORTING ENTITY TOTALS
for the years ended June 30, 1998 and 1997
(In thousands)

| | <u>Teachers'</u> <u>Retirement</u> <u>Fund</u> | <u>Cash</u> <u>Balance</u> <u>Fund</u> | <u>403(b)</u> <u>Program</u> | <u>Reporting Entity Totals</u> | |
|---|--|--|---------------------------------|--------------------------------|----------------------|
| | | | | <u>1998</u> | <u>1997</u> |
| ADDITIONS | | | | | |
| Contributions: | | | | | |
| Members | \$ 1,302,802 | \$ 772 | \$ 5,079 | \$ 1,308,653 | \$ 1,199,159 |
| Employers | 1,371,404 | 772 | -- | 1,372,176 | 1,250,074 |
| State of California | 1,004,569 | -- | -- | 1,004,569 | 872,374 |
| Total contributions | <u>3,678,775</u> | <u>1,544</u> | <u>5,079</u> | <u>3,685,398</u> | <u>3,321,607</u> |
| Investment income: | | | | | |
| Net appreciation (realized and unrealized) | | | | | |
| in fair value of investments | 9,973,501 | 77 | 1,736 | 9,975,314 | 8,164,127 |
| Interest, dividends and other investment income | 2,967,177 | 28 | 1,175 | 2,968,380 | 2,850,853 |
| Securities lending income | 1,066,103 | -- | -- | 1,066,103 | 1,142,068 |
| Less investment expenses: | | | | | |
| Cost of lending securities | (1,016,704) | -- | -- | (1,016,704) | (1,093,044) |
| Other | (40,577) | -- | -- | (40,577) | (43,433) |
| Net investment income | <u>12,949,500</u> | <u>105</u> | <u>2,911</u> | <u>12,952,516</u> | <u>11,020,571</u> |
| Other income | <u>748</u> | <u>--</u> | <u>--</u> | <u>748</u> | <u>729</u> |
| Total additions | <u>16,629,023</u> | <u>1,649</u> | <u>7,990</u> | <u>16,638,662</u> | <u>14,342,907</u> |
| DEDUCTIONS | | | | | |
| Retirement, death and survivor benefits | 2,923,753 | -- | 165 | 2,923,918 | 2,753,640 |
| Refunds of member contributions | 69,047 | -- | 1,662 | 70,709 | 66,791 |
| Purchasing power benefits | 179,385 | -- | -- | 179,385 | 159,383 |
| Administrative expenses | 36,339 | 397 | 155 | 36,891 | 37,618 |
| Interest expense | -- | 69 | -- | 69 | 35 |
| Total deductions | <u>3,208,524</u> | <u>466</u> | <u>1,982</u> | <u>3,210,972</u> | <u>3,017,467</u> |
| Net increase | <u>13,420,499</u> | <u>1,183</u> | <u>6,008</u> | <u>13,427,690</u> | <u>11,325,440</u> |
| Net assets (deficit) held in trust for pension benefits | | | | | |
| Beginning of year | <u>74,777,836</u> | <u>(393)</u> | <u>19,447</u> | <u>74,796,890</u> | <u>63,471,450</u> |
| End of year | <u>\$ 88,198,335</u> | <u>\$ 790</u> | <u>\$ 25,455</u> | <u>\$ 88,224,580</u> | <u>\$ 74,796,890</u> |

The accompanying notes are an integral part of these financial statements.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS

1. Description of the System and Contribution Information:

The State Teachers' Retirement System (System) is the administrator of cost-sharing multiple-employer pension plans and a tax-deferred supplemental program, as described below, established and administered by those sections of the State Education Code known as the State Teachers' Retirement Law (Section 22000 et. seq.), which assigns the authority to establish and amend the benefit provisions of the System to the State of California (State) Legislature. The System is a component unit of the State of California. These financial statements include only the accounts of the System. The System's financial statements are included as a trust fund in the financial statements of the State of California. The System provides pension benefits to California full-time and part-time public school teachers from preschool through grade fourteen and certain other employees of the public school system.

Teachers' Retirement Fund (TRF)

The TRF is a defined benefit pension plan. At June 30, 1998, there were approximately 1,157 contributing employers (school districts, community college districts, county offices of education and regional occupational programs). The State is a nonemployer contributor to the TRF. Membership is mandatory for all employees meeting the eligibility requirements. At June 30, 1997, membership consisted of:

| | |
|---|---------------------------|
| Active members: | |
| Vested | 227,509 |
| Nonvested | 136,491 |
| Inactive members | 59,385 |
| Retirees and benefit recipients | <u>153,639</u> |
| Total members, retirees and beneficiaries | <u><u>577,024</u></u> |

Information as of June 30, 1998, will not be available until November 1998.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

1. Description of the System and Contribution Information, continued:

TRF provides defined retirement benefits based on members' final compensation, age, and years of credited service. In addition, the retirement program provides benefits to members upon disability, and to survivors upon the death of eligible members. Benefit provisions include:

- After five years of credited California service, members become 100% vested in retirement benefits earned to date. Members are eligible for normal retirement at age 60. The normal retirement benefit is equal to 2% of final compensation for each year of credited service. Final compensation is defined as the highest average annual compensation earnable during either any three consecutive years of credited service, or twelve consecutive months if the employer elects to pay the additional cost for classroom teachers. Early retirement options are available at age 55 or as early as age 50 with 30 years of credited service.
- After five years of credited California service, a member (prior to age 60 if under coverage A, no age limit if under coverage B) is eligible for disability benefits of up to 50% of final compensation plus 10% of final compensation for each eligible child, up to a maximum of 40%. The member must have a disability that will exceed a period of twelve or more months to qualify for a benefit.
- A family benefit is available if the deceased member had at least one year of credited service.
- Members' accumulated contributions are refundable with interest upon separation from the System. The 1997-98 fiscal year rate of interest credited to members' accounts is 6.25%.

Purchasing power protection is provided to those benefit recipients whose purchasing power has been reduced below certain levels. The purchasing power protection is funded by a combination of School Lands Revenue and Supplemental Benefit Maintenance Account (SBMA) contributions. School Lands Revenue is appropriated pursuant to Public Resources Code Section 6217.5 from the use of school lands.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

1. Description of the System and Contribution Information, continued:

The Cecil Green/William Campbell/Dave Elder Act (Act) of 1989 (Education Code Section 22954) established the SBMA to provide annual distributions (in quarterly payments) to retired and disabled members, and beneficiaries in order to restore purchasing power to a minimum of 68.2% of the initial monthly allowance. The Mrs. Ruth Q. dePrida Pension Protection Act, SB 1026 (Schiff), Chapter 939, Statutes of 1997 increased the minimum purchasing power to 75%, effective January 1, 1998. The State's contributions for the year ended June 30, 1998 were sufficient to meet the purchase power obligations.

Required Contributions

Actual member and employer rates are set by the State Teachers' Retirement Law which assigns the authority to establish and amend contribution requirements to the State Legislature. Required contribution rates are expressed as a level percentage of payroll using the entry age normal actuarial cost method. The System also uses the level percentage of payroll method to calculate the amortization of the unfunded liability.

A summary of statutory rates and other sources of contributions to the System is as follows:

- | | | |
|---------------------|---|--|
| Members | - | 8% of applicable member earnings |
| Employers | - | 8.25% of applicable member earnings |
| State of California | - | The enactment of SB 1370 (Ed. Code Section 22955), known as the "Elder Full Funding Act," provides for eventual full funding for the System. The provisions of the bill which became effective July 1, 1990, replaced the prior State contribution with a new funding mechanism beginning July 1, 1991. The State's annual contribution to the System is 4.3% of the previous calendar year's member payroll. Subsequent to achieving a fully funded System, the State will contribute only the amount necessary to help fund the normal cost of the current benefit program unless a subsequent unfunded obligation occurs. |

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

1. Description of the System and Contribution Information, continued:

- A statutory employer contribution rate of .415% (approximately \$64 million in fiscal 1997-98) of payroll under Education Code Sections 22952 and 22953. These are employer contributions appropriated by the State to the System pursuant to the Education Code. Actual State appropriations were approximately \$45 million (approximately .294% of covered payroll) for the year ended June 30, 1998.

In their most recent actuarial valuation as of June 30, 1997, the System's independent actuaries determined the estimated amortization period for the unfunded obligation computed using the cost method and the statutory contribution rates as described above. Based on this valuation, the current statutory contributions are equivalent to 20.48% of covered payroll. The current level of contributions is sufficient to fund normal cost and amortize the unfunded actuarial accrued liability of \$1.87 billion at June 30, 1997, by the year 2000. Once amortization is complete, the State contribution will drop to the level necessary to help fund the normal cost of the current benefit program. Certain risks related to the global financial markets may affect the fair value of the System's investment portfolio. The System's management is continually evaluating the impact of market fluctuations on the unfunded actuarial accrued liability.

Cash Balance Fund (CB Fund)

The CB Fund is the depository for the assets of the Cash Balance Plan (CB Plan) which was established under Part 14 of the California Education Code (Section 26000 et seq.) and subsequently amended by Assembly Bill 2673, as a separate defined benefit plan within the System designed for employees of California's public schools who are hired to perform creditable service for less than 50% of the full-time equivalent for the position. Participation in the CB Plan is optional to school districts, community college districts, county offices of education and regional occupational programs. If a school district, community college district, county office of education, or regional occupational program elects to offer the CB Plan, each eligible employee will automatically be covered by the CB Plan, unless the member elects to participate in TRF or an alternative plan provided by the employer within 60 days of hire.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

1. Description of the System and Contribution Information, continued:

A summary of statutory contribution rates for the CB Fund is as follows:

| | | |
|-----------|---|----------------------------------|
| Members | - | 4% of applicable member earnings |
| Employers | - | 4% of applicable member earnings |

Employers may enter into a collective bargaining agreement to pay different rates if certain minimum conditions are met. Contributions to the CB Fund commenced as of February 1, 1997. At June 30, 1998, there were 13 contributing school districts and approximately 3,507 contributing members.

In their most recent actuarial valuation as of June 30, 1997, the CB Fund's independent actuaries determined the unfunded actuarial accrued liability to be approximately \$557,000. Management believes that the financial condition of the CB Fund will improve when a larger asset base becomes available to fund administrative expenses upon the merger of the TRF and CB Fund (Note 7).

STRS 403(b) Program (403(b) Program)

The 403(b) Program was authorized pursuant to Assembly Bill 3064 and meets the requirements of the Internal Revenue Code Section 403(b). The 403(b) Program plan is a defined contribution plan and is open to any employee who is eligible to participate. Contributions to the program are voluntary and require no minimum limitations, however, the Internal Revenue Code does impose a maximum amount that can be contributed annually. At June 30, 1998, there were approximately 1,498 plan members and approximately 365 participating employers (school districts).

An agreement was entered into between the System and State Street Bank and Trust Company (SSB) on January 1, 1995, to appoint SSB as third-party administrator, record keeper and master custodian for the 403(b) Program assets. The appointment will expire on January 1, 2001. The financial statements include the accounts of the money market, S&P 500, self managed account and loan funds.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies:

Basis of Accounting

The accounting records of the System are maintained on the accrual basis of accounting. Member contributions are recognized in the period in which the contributions are due. Employer and State contributions are recognized when due and the employer or State has made a formal commitment to provide the contributions. Benefits are recognized when due and payable in accordance with System's retirement program.

New Accounting Pronouncements

Effective July 1, 1997, the System implemented Government Accounting Standards Board Statement (GASB) No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, which establishes accounting and financial reporting standards for certain investments, and establishes fair value as the accounting principle for investments that have readily determinable fair values. The adoption of GASB No. 31 had no impact on net assets held in trust for pension benefits at July 1, 1997.

The GASB is currently evaluating a proposed Technical Bulletin, Disclosures About Year 2000 Resources Committed, which is expected to require the System to provide additional disclosures related to its commitment to make Year 2000 compliance changes or updates to computer systems and equipment. The System is currently evaluating the impact of this proposed Technical Bulletin on its disclosures.

Use of Estimates in the Preparation of Financial Statements

The preparation of the System's financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and changes therein, and when applicable, disclosures of contingent assets and liabilities. Actual results could differ from those estimates.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued:

Investments

The majority of the securities held in the investment portfolio at June 30, 1998, are in the custody of or controlled by the SSB, the System's master custodian. State statutes and Board policies allow investments consisting of government, corporate and international bonds, domestic and international equities, mutual funds, limited partnership holdings, real estate, mortgages and other investments.

All investments are reported at fair value. The fair values of investments are generally based on published market prices and quotations from major investment firms. In the case of debt securities acquired through private placements, fair value is computed by management based on market yields and average maturity dates of comparable quoted securities. Investments pooled within the System's reporting entity are valued based upon the fair values of the assets held in the pools. Mortgages are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. Real estate equity investment fair values are based on either recent estimates provided by the System's contract real estate advisors or independent appraisers. Short-term investments are reported at cost or amortized cost, which approximates fair value.

Purchase and sales of debt securities, equity securities and short-term investments are recorded on the trade date. Real estate equity transactions are recorded on the settlement date.

There are certain market risks, credit risks, foreign currency exchange risks, or event risks which may subject the System to economic changes occurring in certain industries, sectors or geographies.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued:

Foreign Exchange Contracts

The TRF enters into forward foreign exchange contracts primarily to minimize the short-term impact of foreign currency fluctuations on the asset and liability positions of foreign investments. Certain external portfolio managers have been authorized to hold forward contracts for investment purposes. As of June 30, 1998, all contracts were held for hedging purposes. These contracts are reported at fair value based on published market prices and quotations from major investment firms. The TRF could be exposed to risk if the counterparties to the contracts are unable to meet the terms of their contracts. The TRF seeks to minimize risk from counterparties by establishing minimum credit quality standards and maximum credit limits.

Administrative Expenses

The 403(b) Program reimburses the TRF for administrative services provided on its behalf.

As allowed by California Education Code Section 26207, the CB Fund borrowed \$1,000,000 from the TRF for administrative costs incurred during fiscal 1996-97, the first year of operation. The advance must be repaid with interest at the regular interest rate as set forth in the Education Code, which was at 6.50% as of June 30, 1998. Payment on the advance will be made from the investment earnings of the plan during years in which the total investment earnings for the plan year exceed the sum of the total amount required to credit all employee and employer accounts at the interest rate set by the Teachers' Retirement Board (STRS Board) plus administrative costs of the plan for the year. Investment earnings in excess of such sum shall first be applied to the repayment of any loan. As of June 30, 1998, the CB Fund owed \$1.29 million to the TRF, which included accrued interest.

Income Taxes

The TRF and CB Fund are organized as tax-exempt retirement plans under the Internal Revenue Code. The 403(b) Program is organized as a tax-deferred supplemental program under the Internal Revenue Code. The System's management believes that it has operated within the constraints imposed by federal tax law.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued:

Investment Expense

Expenses directly associated with investment management have been included as other investment expenses, indirect expenses have not been allocated.

Securities Lending Transactions

The System reports securities lent, the cash collateral held as assets and the related liabilities resulting from security lending transactions on the statement of plan assets. The System also reports the costs of lending securities as investment expenses on the statement of changes in plan net assets.

Reclassifications

Certain prior year balances have been reclassified to conform with the current year presentation.

3. Investments:

The System's investments are categorized below to give an indication of the category risk level assumed by the System at June 30, 1998, as defined by GASB Statement No. 3. Category 1, the lowest risk, includes investments that are insured or registered or for which the securities are held by the System or its agent in the System's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the System's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the System's name. Investment pools managed by other governments, investments held by broker-dealers under securities loans, alternative investments and real estate equity investments are not categorized.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

3. Investments, continued:

The following table presents investments held by TRF by type at June 30, 1998 (in thousands):

| Investment Type | Category 1 | Category 2 | Category 3 | Category Rating Not Required | Fair Value |
|--|----------------------|---------------|---------------|------------------------------------|-----------------------|
| Categorized: | | | | | |
| Short-term investments | \$ 1,466,626 | \$ — | \$ — | \$ 258,402 | \$ 1,725,028 |
| Debt securities | 16,718,122 | — | — | — | 16,718,122 |
| Equity securities | 47,958,903 | — | — | — | 47,958,903 |
| Alternative investments | — | — | — | 1,983,165 | 1,983,165 |
| Real estate equity investments | — | — | — | 2,061,342 | 2,061,342 |
| Securities lending collateral | 16,996,456 | — | — | — | 16,996,456 |
| Not categorized: | | | | | |
| Investments held by broker-dealers under securities loans: | | | | | |
| Debt securities | — | — | — | 10,167,366 | 10,167,366 |
| Equity securities | — | — | — | 7,298,372 | 7,298,372 |
| Total investments | <u>\$ 83,140,107</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 21,768,647</u> | <u>\$ 104,908,754</u> |

Short-term investments of the TRF as of June 30, 1998, are comprised of the following (in thousands):

| | |
|---|---------------------|
| Surplus Money Investment Fund (State of California) | \$ 258,402 |
| Repurchase agreements | 4,555 |
| Bankers acceptance | 33,283 |
| Certificates of deposit | 250,001 |
| Commercial paper | 409,229 |
| Treasury bills | 479,075 |
| Foreign currency | 48,967 |
| Short-term agencies | 241,516 |
| Total | <u>\$ 1,725,028</u> |

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

3. Investments, continued:

The TRF's investment in the Surplus Money Investment Fund (SMIF), administered by the state, represents various investments generally with maturity dates of 200 days or less, and is reported at amortized cost which approximates market value.

The TRF's repurchase agreement transactions at June 30, 1998, have underlying collateral with market values of approximately 102% of the cost of the repurchase agreement. The agreed-upon yield is 5% with maturity dates through July 1, 1998.

Foreign currency is comprised of international investment proceeds and income to be repatriated into U.S. dollars and funds available to purchase international securities. Foreign currency is not held as a form of investment.

State statutes and STRS Board policies permit the TRF to lend its securities to broker-dealers and other entities for which collateral is received with a simultaneous agreement to return the collateral for the same securities in the future. TRF has contracted with third party securities lending agents to lend domestic and international equity and debt securities. All securities loans can be terminated on demand by either TRF or the borrower. Collateral in the form of cash or other securities is required for 102% and 105% of the fair value of domestic and international securities, respectively, loaned. As of June 30, 1998, the System has no credit risk exposure to borrowers because the amounts the System owes the borrowers exceed the amounts the borrowers owe the System. Cash collateral is invested in short-term investments, which at year-end have a weighted-average maturity of less than 90 days, and the assets held as collateral are presented in the above table of investments held. TRF is not permitted to pledge or sell collateral securities received unless the borrower defaults. The contracts with the security lending agents require them to indemnify TRF if the borrowers fail to return the securities (or if the collateral is not sufficient to replace the securities lent) or if the borrower fails to pay TRF for income distributions by the securities' issuers while the securities are on loan.

CB Fund

The investments of the CB Fund were maintained in the SMIF or pooled with TRF. Investment in SMIF is stated at amortized cost which approximates market and is not required to be categorized under GASB Statement No. 3.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

3. Investments, continued:

The CB Fund owns less than .01% of equity and debt securities pools sponsored by TRF. The assets held by the equity and debt securities pools are categorized as Category 1 under GASB Statement No. 3.

403(b) Program

Investments held by the 403(b) Program are mutual funds and are not required to be categorized by risk levels under GASB Statement No. 3.

4. Cash and Cash Equivalents:

Cash and cash equivalents of \$4.409 million held by TRF are collateralized and classified as risk Category 1 investments under GASB Statement No. 3.

5. Contingencies:

The TRF is involved in litigation relating to various matters. In the opinion of management, after consultation with legal counsel, the outcome of this litigation will not have a material adverse effect on the TRF's financial position.

6. Commitments:

In conjunction with the purchase of various partnership interests, the TRF has remaining funding commitments of approximately \$2.3 billion at June 30, 1998.

The TRF has entered into agreements to guarantee the payment of principal and interest in the event that the primary obligator defaults. The TRF is paid a fee over the term of the agreement, and in the event of default, the TRF could draw on the standby letter-of-credit for repayment. At June 30, 1998, the TRF has commitments of approximately \$489.4 million expiring through June 30, 2003. Fee income earned by TRF was \$1.129 million for the year ended June 30, 1998.

STATE TEACHERS' RETIREMENT SYSTEM
NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS, Continued

7. Subsequent Events:

Merger of TRF and CB Fund

On September 30, 1998, the State's Governor signed into law SB 2085 that would require the System's CB Fund to merge into TRF effective January 1, 1999. The law provides, among other things, that both the Defined Benefit Program and the Cash Balance Benefit Program would be included in the Teachers' Retirement Law and that they would both be known and cited as the State Teachers' Retirement Plan (STRP). The new legislation also requires that the cost of administration will be divided proportionately based on the assets of the separate programs and that all administrative costs of the Cash Program will be paid from the TRF. Additionally, the prior loan from the TRF to the CB Fund will be discharged by the creation of the STRP.

SUPPLEMENTAL INFORMATION

STATE TEACHERS' RETIREMENT SYSTEM
Teachers' Retirement Fund and Cash Balance Fund
Schedule of Funding Progress
June 30, 1998

| <u>Actuarial Valuation Date As of June 30,</u> | <u>Actuarial Value of Assets</u> | <u>Actuarial Accrued Liability (AAL)</u> | <u>Unfunded AAL (UAAL)</u> | <u>Funded Ratio (a/b)</u> | <u>Covered Payroll (c)</u> | <u>UAAL as a % of Covered Payroll (b-a)/c</u> |
|--|--|--|------------------------------------|-----------------------------------|------------------------------------|---|
| | (a) | (b) | (b-a) | | | |

Teachers' Retirement Fund (dollars in millions):

| | | | | | | |
|------|----------|----------|---------|-----|----------|-----|
| 1998 | (1) | (1) | (1) | (1) | (1) | (1) |
| 1997 | \$67,980 | \$69,852 | \$1,872 | 97% | \$14,521 | 13% |
| 1996 | (1) | (1) | (1) | (1) | (1) | (1) |
| 1995 | 55,207 | 63,391 | 8,184 | 87% | 12,688 | 65% |
| 1994 | (1) | (1) | (1) | (1) | (1) | (1) |
| 1993 | 45,212 | 53,581 | 8,369 | 84% | 11,994 | 70% |

Cash Balance Fund (dollars in thousands):

| | | | | | | |
|------|---------|-------|-------|--------|---------|-----|
| 1998 | (2) | (2) | (2) | (2) | (2) | (2) |
| 1997 | \$(393) | \$164 | \$557 | (240)% | \$4,504 | 12% |

(1) No actuarial report is prepared in even-numbered years for the Teachers' Retirement Fund. No estimation using actuarial methodology is made in years between valuations.

(2) The 1998 actuarial report for the Cash Balance Fund will be available in November 1998.

STATE TEACHERS' RETIREMENT SYSTEM
Teachers' Retirement Fund and Cash Balance Fund
Schedule of Contributions from Employers
and Other Contributing Entities
June 30, 1998
(Dollars In Thousands)

| <u>Year Ended June 30</u> | <u>Annual Required Contribution</u> (a) | <u>Contributed by Employers (1)</u> (b) | <u>Contributed By the State (2)</u> (c) | <u>Total Contributed</u> (b + c) | <u>Percentage Contributed</u> ((b + c)/a) |
|-----------------------------------|--|--|--|---|--|
|-----------------------------------|--|--|--|---|--|

Teachers' Retirement Fund:

| | | | | | |
|------|-------------|-------------|-----------|-------------|------|
| 1998 | \$1,911,466 | \$1,419,212 | \$586,946 | \$2,006,158 | 105% |
| 1997 | 1,835,329 | 1,299,163 | 550,117 | 1,849,280 | 101% |
| 1996 | 1,725,955 | 1,195,768 | 530,187 | 1,725,955 | 100% |
| 1995 | 1,588,892 | 1,110,979 | 518,816 | 1,629,795 | 103% |
| 1994 | 1,586,360 | 1,125,971 | 517,944 | 1,643,915 | 104% |
| 1993 | 1,583,832 | 1,084,249 | 510,757 | 1,595,006 | 101% |

Cash Balance Fund:

| | | | | | |
|------|-------|-------|-------|-------|------|
| 1998 | \$772 | \$772 | \$-0- | \$772 | 100% |
| 1997 | \$ 74 | \$ 74 | \$-0- | \$ 74 | 100% |

- (1) For TRF, includes additional employer contributions under Sections 22950 to 22953 and 22955.
- (2) For TRF, includes SB 1370 (Elder Full Funding Act) representing additional amounts to maintain the full value of the contribution schedule required by statute.

STATE TEACHERS' RETIREMENT SYSTEM
Teachers' Retirement Fund and Cash Balance Fund
Schedule of Contributions from Employers
and Other Contributing Entities, Continued
June 30, 1998

The information presented in the required Supplementary Schedules 1 and 2 was determined as part of the actuarial valuations at June 30, 1997. Additional information is as follows:

| | TRF | CB Fund |
|--------------------------------------|--|-------------------------------|
| Actuarial Cost Method | Entry age normal | Traditional Unit Credit |
| Amortization Method | Level percent of payroll | Not applicable |
| Amortization Period | Open | Not applicable |
| Remaining Amortization Period | 3 years | Not applicable |
| Asset Valuation Method | Expected value with 25% adjustment to market value | Market value of net assets |
| Actuarial Assumptions: | | |
| Investment rate of return | 8.0% | 7.0% |
| Projected salary increases | 5.5% | 5.5% |
| Consumer price inflation | 4.5% | 4.5% |
| Post-retirement benefit increases | 2.0% simple | Not applicable |

The above assumptions for TRF were not changed from the previous actuarial valuation as of June 30, 1995. The CB Fund performed it's first actuarial valuation as of June 30, 1997.

STATE TEACHERS' RETIREMENT SYSTEM
Teachers' Retirement Fund
Schedule of Administrative Expenses
for the year ended June 30, 1998
(In Thousands)

| | |
|---|------------------|
| Personal services: | |
| Salaries and wages | \$ 18,015 |
| Staff benefits | 5,432 |
| Accrued vacations | (18) |
| | <u>23,429</u> |
| Operating expenses and equipment | |
| General expense | 1,035 |
| Depreciation expense | 66 |
| Printing | 593 |
| Communications | 615 |
| Postage | 384 |
| Insurance | 10 |
| Travel | 175 |
| Training | 196 |
| Facilities operations | 2,468 |
| Consultants and professional services | 3,900 |
| Consolidated data center: | |
| Consultants and professional services | 1,476 |
| Data processing: | |
| Consultant and professional services | 2,557 |
| Software and other | 125 |
| Central administrative services | 1,016 |
| Equipment | 58 |
| Other | 4 |
| | <u>14,678</u> |
| Total current year expenses that are budgeted | 38,107 |
| Past prior year expenses (recoveries) | <u>(1,768)</u> |
| Total | <u>\$ 36,339</u> |
| Fund sources: | |
| SBMA / administration expense | \$ 60 |
| Reimbursements | 474 |
| Accrued vacation expense | (18) |
| Budget Act, Chapter 303, Statutes 1995 | (19) |
| Budget Act, Chapter 162, Statutes 1996 | (1,395) |
| Reappropriated Chapter 303, by Chapter 162/96 | 10 |
| Reappropriated Chapter 162, by Chapter 282/97 | 1,121 |
| Budget Act, Chapter 282, Statutes 1997 | 36,106 |
| Total funding | <u>\$ 36,339</u> |

STATE TEACHERS' RETIREMENT SYSTEM**Schedule 4****Teachers' Retirement Fund****Schedule of Investment Expenses from Continuous Appropriation
for the year ended June 30, 1998****(In Thousands)****External equity managers:****Domestic:**

| | |
|-----------------------------------|------------|
| Barclays Global Investors | \$ 338 |
| Brown Capital Management Inc. | 245 |
| Denver Investment Advisor Inc. | 840 |
| NCM Capital Management Group Inc. | 333 |
| Oppenheimer Capital | 502 |
| Provident Investment Counsel | 549 |
| Sasco Capital, Inc | <u>586</u> |

| | |
|----------------|--------------|
| Total Domestic | <u>3,393</u> |
|----------------|--------------|

International:

| | |
|--|------------|
| Bank of Ireland | 1,731 |
| Barclays Global Investors | 1,027 |
| Capital Guardian Trust | 2,868 |
| Chancellor LGT Capital Management | 704 |
| J P Morgan Investment Management | 573 |
| Lazard Freres Asset Management | 1,394 |
| Morgan Stanley | 1,287 |
| Oechsle International Advisors | 1,745 |
| Schroder Capital Management Investment, Ltd. | 1,630 |
| Scudder, Stevens & Clark | 1,630 |
| State Street Global Advisors | <u>703</u> |

| | |
|---------------------|---------------|
| Total International | <u>15,292</u> |
|---------------------|---------------|

STATE TEACHERS' RETIREMENT SYSTEM**Schedule 4****Teachers' Retirement Fund****Schedule of Investment Expenses from Continuous Appropriation, Continued
for the year ended June 30, 1998****(In Thousands)****External equity managers, continued:****Global:**

| | |
|-------------------------------|----------|
| Baring International | \$ 3,064 |
| Brinson Partners | 1,912 |
| Fiduciary Trust International | 2,412 |
| Trust Company of the West | 44 |

| | |
|--------------|-------|
| Total Global | 7,432 |
|--------------|-------|

| | |
|--------------------------------|--------|
| Total External Equity Managers | 26,117 |
|--------------------------------|--------|

Real Estate Managers/Advisors:

| | |
|--|-------|
| AMB Institutional Reality Advisor Inc. | 4,919 |
| ERE Yarmouth | 2,387 |
| MIG Realty Advisors, Inc. | 327 |
| O'Connor Realty Advisor Inc. | 751 |
| SSR Realty Advisors | 413 |
| Trust Company of the West | 1,576 |

| | |
|-------------------------------------|--------|
| Total Real Estate Managers/Advisors | 10,373 |
|-------------------------------------|--------|

Advisors and Consultants:

| | |
|------------------------------------|-----|
| AEW Capital Management, L.P. | 100 |
| Abbott Capital Management, L.P. | 386 |
| Thomas Flanigan, Inc. | 110 |
| Pathway Capital Management, L.L.C. | 499 |
| Pension Consulting Alliance | 367 |
| The Roulac Group | 28 |
| Real Desrochers | 27 |

| | |
|--------------------------------|-------|
| Total Advisors and Consultants | 1,517 |
|--------------------------------|-------|

STATE TEACHERS' RETIREMENT SYSTEM**Schedule 4****Teachers' Retirement Fund****Schedule of Investment Expenses from Continuous Appropriation, Continued
for the year ended June 30, 1998****(In Thousands)**

| | |
|--|-------------------------|
| Attorneys, Master Custodian and Insurers: | |
| Blank, Rome Comiskey and McCauley | \$ 6 |
| Cox, Castle & Nicholson | 19 |
| Fulbright & Jaworski | 2 |
| Groom & Nordberg | 89 |
| Kanter Immigration Law Office | 2 |
| Near North Insurance Brokerage | 245 |
| Orrick, Herrington & Sutcliffe | 3 |
| Quateman & Zidell | 1 |
| State Street Bank & Trust Co. | <u>1,825</u> |
| Total Attorneys, Master Custodian and Insurers | <u>2,192</u> |
| Other Expenses: | |
| Cortex Applied Research, Inc. | 106 |
| Russell Reynolds, Inc. | 5 |
| State Controller's Office | 24 |
| Miscellaneous | 157 |
| Travel | <u>86</u> |
| Total Other Expenses | <u>378</u> |
| Total continuous appropriations | <u><u>\$ 40,577</u></u> |

STATE TEACHERS' RETIREMENT SYSTEM
Teachers' Retirement Fund
Schedule of Consultant and Professional Services Expenses
for the year ended June 30, 1998
(In Thousands)

Schedule 5

| <u>INDIVIDUAL OR FIRM</u> | <u>COMMISSION/ FEE</u> | <u>NATURE OF SERVICE</u> |
|--|----------------------------|------------------------------------|
| Consulting and Professional Services: | | |
| Alameda County Office of Education | \$ 72 | Regional Counseling Services |
| Bay Brook Medical Group, Inc. | 91 | Disability Evaluation |
| Carole Nimietz, M. ED., CRC | 19 | Vocational Assessments and Reports |
| Contra Costa County Office of Education | 70 | Regional Counseling Services |
| Coopers & Lybrand | 45 | Auditing Services |
| Department of General Services | 43 | Hearing Office Charges |
| Department of Justice | 239 | General Services Legal Fees |
| Department of Personnel Administration | 81 | Legal Services |
| Fresno County Office of Education | 57 | Regional Counseling Services |
| Geary & Associates, Inc. | 20 | Vocational Assessments and Reports |
| Goldfarb & Associates | 18 | Vocational Assessments and Reports |
| Hogan & Hartson | 150 | Advocate & Legal Representation |
| JHME Advertising | 26 | Graphic Art Design |
| Kathleen M. Ogburn | 18 | Vocational Assessments and Reports |
| Kern County Superintendent of Schools | 45 | Regional Counseling Services |
| Liebmman & Associates | 66 | Vocational Assessments and Reports |
| Linville Associates | 20 | Vocational Assessments and Reports |
| Los Angeles County of Education | 52 | Administrative Services |
| Los Angeles County Superintendent of Schools | 467 | Regional Counseling Services |
| Merced County Office of Education | 13 | Regional Counseling Services |
| Milliman & Robertson | 25 | Actuarial Services |
| Orange County Office of Education | 123 | Regional Counseling Services |
| San Bernardino County School District | 126 | Regional Counseling Services |
| San Diego Unified School District | 160 | Regional Counseling Services |
| San Joaquin County Office of Education | 49 | Regional Counseling Services |
| San Juan Unified School District | 114 | Regional Counseling Services |
| San Mateo-Foster City School District | 93 | Regional Counseling Services |
| Santa Barbara County Office of Education | 52 | Regional Counseling Services |
| Santa Clara County Office of Education | 99 | Regional Counseling Services |
| Santa Cruz County Office of Education | 45 | Regional Counseling Services |
| Shasta County Office of Education | 53 | Regional Counseling Services |
| Sonoma County Supt. of Schools | 46 | Regional Counseling Services |
| State Controllers Office | 673 | Various Financial Services |
| Superior Rehabilitation Services | 36 | Vocational Assessments and Reports |
| Towers, Perrin, Forester | 40 | Consulting Services |
| Travel/Tuition | 68 | Medical Reimbursement |

STATE TEACHERS' RETIREMENT SYSTEM

Schedule 5

Teachers' Retirement Fund

Schedule of Consultant and Professional Services Expenses, Continued
for the year ended June 30, 1998
(In Thousands)

| <u>INDIVIDUAL OR FIRM</u> | <u>COMMISSION/ FEE</u> | <u>NATURE OF SERVICE</u> |
|--|----------------------------|--|
| Consulting and Professional Services, continued: | | |
| Tulare County Superintendent of Schools | 17 | Regional Counseling Services |
| Ventura County Superintendent of Schools | 32 | Regional Counseling Services |
| Volkoff, Brian | 15 | Computer Programming |
| Watson Wyatt Company | 115 | Actuarial Services |
| William M. Mercer | 75 | Consulting Services |
| Other | <u>232</u> | Various Services - each individual order was paid less than \$10,000 for the services provided |
| Total | <u>3,900</u> | |
| Data Processing: | | |
| Advanced Business Integrators | 6 | Data Processing |
| Clientele Software | 4 | Data Processing |
| Computer Resources Group | 91 | Data Processing |
| Enterprise Technology Solution | 5 | Data Processing |
| Entex Information Services | 5 | Data Processing |
| Nanran, Inc. | 659 | Data Processing |
| Quest Media & Supplies | 1 | Data Processing |
| Science Applications | 123 | Data Processing |
| SPL Worldgroup Consulting | 1,122 | Data Processing |
| Synergy Consulting, Inc. | 379 | Data Processing |
| Visionary Integration | <u>162</u> | Data Processing |
| | <u>2,557</u> | |
| Consolidated Data Center: | | |
| Teale Data Center | 1,464 | Consolidated Data Center |
| HWDC | <u>12</u> | Consolidated Data Center |
| | <u>1,476</u> | |
| Total Consultant and Professional Services Expenses | \$ <u>7,933</u> | |

STATE TEACHERS' RETIREMENT SYSTEM
Cash Balance Fund
Schedule of Administrative Expenses
for the year ended June 30, 1998
(In Thousands)

Personal services:

| | |
|--------------------|------------|
| Salaries and wages | \$ 96 |
| Staff benefits | <u>29</u> |
| | <u>125</u> |

Operating expenses and equipment:

| | |
|--------------------------------------|------------|
| General expense | 189 |
| Printing | 24 |
| Consultant and professional services | 51 |
| Travel | 7 |
| Data Processing | <u>1</u> |
| | <u>272</u> |

| | |
|-------------------------|----------------------|
| Total budgeted expenses | \$ <u><u>397</u></u> |
|-------------------------|----------------------|

Funding source:

| | |
|--|---------------|
| Budget Act, Chapter 592, Statutes 1995 | \$ <u>397</u> |
|--|---------------|

| | |
|---------------|----------------------|
| Total funding | \$ <u><u>397</u></u> |
|---------------|----------------------|

STATE TEACHERS' RETIREMENT SYSTEM
Cash Balance Fund
Schedule of Consultant and Professional Services Expenses
for the year ended June 30, 1998
(In Thousands)

| <u>Individual or Firm</u> | <u>Commision/ Fees</u> | <u>Nature of Service</u> |
|---------------------------|----------------------------|--------------------------|
| CSUS Foundation | \$ 2 | Consulting Services |
| Milliman & Robertson | 4 | Actuarial Services |
| Watson Wyatt | <u>45</u> | Actuarial Services |
| Total | <u>\$ 51</u> | |

STATE TEACHERS' RETIREMENT SYSTEM
403(b) Program
Schedule of Administrative Expenses
for the year ended June 30, 1998
(In Thousands)

| | |
|---------------------------------------|----------------------|
| State Street Bank administrative fees | \$ 145 |
| Teachers' Retirement Fund sponsor fee | <u>10</u> |
| Total | \$ <u><u>155</u></u> |